The Response of Investment and Growth to Adjustment Policies

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The basic pillars of economic growth—investment and saving—are strongly influenced by the private sector’s confidence in a country’s policies. The timeliness, sustainability, and consistency of policies are therefore critically important.

A recent IMF study asked how adjustment policies could better contribute to reinvigorating medium-term growth in developing countries. To answer this question, the study examined the influence of macroeconomic policies and core structural reforms on the investment, saving, and growth performances of eight developing countries (Bangladesh, Chile, Ghana, India, Mexico, Morocco, Senegal, and Thailand) since 1970. The impetus for this study came from a review of IMF-supported adjustment programs. (See the article by Susan Schadler in this issue.)

Most of the eight countries suffered adverse external shocks—higher oil prices, falling commodity export prices, and rising world interest rates—during the latter half of the 1970s and the early 1980s. Their initial responses to these shocks typically included expansionary policies, mainly the running up of large fiscal deficits, sometimes combined with new or intensified import restrictions and exchange controls. These policies exacerbated, rather than relieved, an already difficult situation by fueling inflation or increasing external debt burdens, or both. In many cases, the result was a macroeconomic crisis, frequently involving a severe external financing constraint that entailed an abrupt shift in net resource flows. The subsequent adjustment program typically had to begin with efforts to restore macroeconomic stability. The adjustment effort started in the early 1980s and continued up to the present time for all countries except Chile and India.

The short-term declines in output, investment, and measured productivity resulting from the crisis and early adjustment were especially dramatic in Chile (both in 1975 and 1982) and Mexico (in 1982–83). Most other countries experienced a more moderate slowdown in growth. Private investment as a share of GDP typically fell for several years, while cuts in public investment were part of the fiscal consolidation. An exception was Ghana, where growth picked up quickly as a severe import compression was reversed in 1983.

In the medium term, Chile, Thailand, and—to a lesser extent—Ghana succeeded in achieving sustained growth rates that were higher than those prevailing before the implementation of adjustment policies. Both Chile and Thailand also achieved a marked and sustained increase in private investment, supported by higher domestic savings and capital inflows. In many of the other countries—especially Bangladesh, Mexico, Morocco, and Senegal—the recorded gains in output growth were modest at best, and in some (India, Mexico, and Morocco) the recovery in private investment occurred only after a “pause” of a few years.

Economic stability

One approach to answering the question of whether economic stability matters for growth is to compare growth rates for each of the eight countries with world average growth rates after taking into account the effects on growth of key, longer-term influences (such as investment and terms-of-trade movements) and of macroeconomic policies. This amounts to comparing each country’s performance with a control group that is modified to take account of these broader influences on growth. Of course, all such comparisons involve potential pitfalls, since it is difficult to predict what would have happened in the absence of adjustment.

This comparison indicates that countries experiencing episodes of severe macroeconomic instability—Chile in the early 1970s, Ghana prior to 1983, and Mexico in the aftermath of the 1980s debt crisis—typically had growth rates well below the world average during those episodes. Moreover, following implementation of their adjustment programs and restoration of macroeconomic stability, both Chile and Ghana achieved growth rates well above the world average. Thus, after controlling for other influences on growth, policies oriented toward supporting macroeconomic stability do appear to be beneficial to rapid recovery of output.

However, there is more to the story than stability. In Mexico, on the one hand,

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significant stabilization was achieved in the aftermath of the debt crisis, yet recorded growth rates have barely recovered to the world average. Thailand, on the other hand, enjoyed prolonged macroeconomic stability, yet it achieved growth rates above the world average both before and after adjustment. Both experiences suggest important additional roles for confidence in a country’s policies and for structural factors.

Growth-fostering policies
Three aspects of policies—timeliness, sustainability, and consistency—are crucial for investor confidence. An inappropriate design of adjustment policies may prolong or contribute to macroeconomic instability and uncertainty, and thus sap private sector confidence.

Delaying adjustment until the point of crisis will generally result in a longer and more protracted slowdown of output growth for three principal reasons. First, the rapid contraction in domestic demand will leave little time for resources to be reallocated to cushion the impact on output. Second, policies undertaken in a crisis may well include ad hoc measures that are not conducive to investment and growth. Evidence suggests that, at least initially, fiscal adjustment in many of the countries discussed was not based on growth-oriented changes in tax and expenditure systems. (See the article by George A. Mackenzie and David W.H. Orsom in this issue.) Third, in a crisis environment, private sector confidence weakens, which, in turn, is likely to reduce the effectiveness of adjustment policies. For example, a tightening of fiscal policy should be partly offset by “crowding in” of private investment, since the reduced demand for credit by the public sector would entail lower interest rates and more credit being available to the private sector. However, expectations of policy reversals may induce investors to take a “wait-and-see” attitude, thereby stalling growth.

Progress toward sustainability of economic policies can foster private sector confidence by reducing concerns about policy reversals. One limited yet useful criterion for gauging sustainability is a fiscal balance that will maintain a constant ratio of public debt to GDP, in the context of low inflation and market-determined interest rates. Judged by this criterion, Thailand’s deficit was broadly sustainable from the outset of adjustment. This perception probably contributed to the relatively rapid increase in private investment. The other seven countries all made progress toward a sustainable fiscal position. However, in several of them (notably Morocco), such a position was reached only after several years; and in others (Ghana and India), the improvement was later partly reversed, probably delaying the “crowding in” of private investment. Moreover, the initially slow response of private investment to a strong fiscal adjustment, especially in Mexico, is probably closely linked to the debt crisis. The sudden loss of external financing meant that even a sharply reduced deficit had to be financed largely from domestic sources, which put considerable upward pressure on interest rates, thereby squeezing private investment.

Consistency between the elements of macroeconomic policies is crucial. The mix of fiscal and monetary policy must include strong enough fiscal adjustment to minimize upward pressure on interest rates and increase private sector access to bank credit. Moreover, the policy mix should be kept under review to ensure its consistency with the overall macroeconomic objectives, in view of the unpredictable shifts in private sector saving and investment behavior at a time of substantial changes in macroeconomic and structural policies. In Mexico, even though fiscal policy was sustainable when gauged by the above-mentioned criterion, the external position proved to be untenable owing to an unexpectedly sharp fall in private saving. The coordination of fiscal, exchange rate, and wage policies is also essential to establishing policy credibility and strengthening external competitiveness. In both Chile and Thailand (after 1984), depreciations of the nominal exchange rate led to significant gains in external competitiveness as fiscal consolidation held domestic price pressures in check. These improvements were supported by the suspension of compulsory wage indexation in Chile (in 1982) and, in Thailand, by the flexibility of the labor market, which facilitated the necessary adjustments in real wages.

**Why an investment pause?**
Most of the eight countries experienced a considerable decline in private investment, either before or during the early part of their adjustment programs, amounting to 3–4 percentage points of GDP. Moreover, in some countries (Mexico, Morocco, and, to a lesser extent, India) private investment remained at this more depressed level for 2–4 years before beginning a recovery. In other countries (Bangladesh, Ghana, and Senegal), the recovery started earlier but was weak and uneven.

An examination of the behavior of investment in the eight countries indicates that both the credibility of policies and the degree of macroeconomic instability and uncertainty are important influences on the forward-looking decisions of private investors. If investors are concerned that a market environment is highly uncertain, they may delay investing until a more positive assessment can be reached. This may lock the economy into a low-investment, low-growth equilibrium if a sufficient number of firms postpone investments. In contrast, policies perceived as consistent and unlikely to be reversed may turn expectations around and induce private investors to go ahead with their plans, thereby reducing the costs of adjustment.

These influences appear to have been especially important in Ghana, where both the lingering impact of foreign exchange controls and slippages in financial policies induced the 1992–93 investment decline; in Mexico, where persistent high inflation was an important deterrent to real private investment during 1983–87; and in Senegal, where inflation and rising external debt contributed to holding back investment in the early 1980s.

Economic policies were also found to influence investment through several other channels: changes in the level of economic activity (capturing the contractionary impact of adjustment policies and confidence effects), as well as real interest rates and the supply of credit to the private sector (reflecting the effects of the mix of fiscal and monetary policies and financial sector reforms). In six countries, public investment was found to compete with and crowd out private investment, implying that selective rationalization of public investment would help to promote private investment. However, this is an issue where generalizations are difficult, since investment in some components of public infrastructure may well encourage private investment.
Why a slow saving response?

Only Chile and Thailand achieved large and lasting increases in their saving rates. By contrast, Bangladesh, Ghana, Morocco, and Senegal achieved moderate increases in saving rates during adjustment, although Ghana’s gain was short-lived.

In most countries, the increase in saving resulted primarily from higher public saving, although this was partly offset by decreased private saving. This offset, typically on the order of 50 percent, suggests the need to be cautious about projections of a recovery in overall saving, especially in the short term. Also, when public saving is raised at the expense of current expenditures, such as primary education—that should more correctly be measured as investment in human capital—it may harm growth prospects. The impact of other policy-related factors, including real interest rates, were, however, found to be small. Large terms-of-trade fluctuations and supply shocks also played a substantial role in Ghana, Morocco, and Senegal.

On the one hand, strong fiscal adjustment contributed to the saving performances of Chile and Thailand. Moreover, the offset between public and private saving was moderated by a history of macroeconomic stability and a fall in the dependency ratio (the share of the old and the young in the total working-age population) in Thailand, and public sector reforms (of the tax, public enterprise, and pension systems) in Chile. Mexico, on the other hand, has recorded a marked decline in national saving, resulting from a boom in consumer spending. This boom was fueled by concerns about policy reversals, eased liquidity constraints, and expectations of higher real incomes.

Structural reform

Macroeconomic adjustment efforts must be accompanied by structural reforms aimed at improving the efficiency of resource allocation and productivity in order to permanently increase a country’s growth rate.

Those countries that began with relatively small structural distortions (Thailand) or made significant progress toward eliminating major distortions (Chile and Ghana) experienced the greatest productivity gains. In contrast, Senegal’s slow and faltering progress in structural reform appears to have yielded few productivity gains. The modest gains in measured productivity developments in Mexico and Morocco cannot be explained solely by the extent of their structural distortions; both countries had only moderate distortions to begin with and both made major progress in carrying out several aspects of reform. Some observers have noted that growth in newly emerging sectors of the Mexican economy may not have been fully recorded. Moreover, important weaknesses in Mexico’s financial and agricultural sectors either remain or have been addressed too recently for the reforms to have had their full impact. The same is true of Morocco’s financial sector and the development of its human capital.

There is also evidence that certain clusters of coordinated reforms can provide a critical mass that will enhance efficiency gains. The linkages among reforms can, however, vary from country to country, and structural reforms will also be more effective if implemented along with restoration of macroeconomic stability. Three clusters of reforms stand out. First, the economy’s supply response to trade reforms is influenced by the strength of supporting sectoral reforms, such as reducing the dominance of the public sector (Bangladesh, Ghana, and India); building a legal infrastructure to accompany reductions in industrial licensing requirements (India); and increasing labor market flexibility (notably Chile and India). Second, it is critically important that bank supervision and regulation be strengthened at the same time that the financial sector is liberalized. Otherwise, a serious banking crisis may result, as in Chile during the early 1980s, when its banking regulations were too weak to prevent rapid growth in the volume of nonperforming loans. Third, inadequate public enterprise reforms can be a major obstacle to the development of efficient financial intermediation. Decisions to support a weak public enterprise sector—as were made, for example, in Bangladesh, Ghana, India, and Senegal—have resulted in large intermediation costs and high lending rates, which, in turn, risk dampening the private investment response.

Key lessons

The linkages between a country’s policies and its economic growth are often indirect and can operate with significant and variable lags. Moreover, many factors other than policies have an impact on growth. Nevertheless, macroeconomic and structural policies clearly matter. How can the design and implementation of adjustment policies help foster growth? The different experiences of two countries that appear to have achieved higher sustained growth rates—Chile and Thailand—suggest that no single blueprint exists. Still, two central themes emerge despite the difficulties of generalizing from a small group. First, market assessments of the internal consistency and sustainability of policies greatly influence the size and speed of the response to forward-looking decisions such as private investment and saving. Second, in each country, there appear to be close links between particular aspects of macroeconomic and structural reforms that are likely to be mutually supporting; hence the importance of a critical mass.

Several specific lessons for the design of adjustment policies stem from these propositions:

• Delayed adjustment is costly. Stabilization policies implemented in a macroeconomic crisis will generally have deeper contractionary effects than those implemented in a more timely fashion.

• A forward-looking, medium-term framework is essential, in order to ensure the sustainability and consistency of policies that can prevent an economy from being locked into a low-investment, low-growth equilibrium.

• Fiscal adjustment should be strong enough both to minimize any adverse effects on private investment and to support real exchange rate adjustment to promote resource switching and thereby minimize the initial contraction of output.

• Increasing public saving is likely to be the most effective means of raising national saving in the short run, although a partially offsetting decrease in private saving should typically be expected.

• Structural reforms need an early start. In each country discussed, there were strong indications that certain types of structural reform tend to reinforce each other, suggesting that carefully combining mutually supportive reforms is likely to maximize their beneficial impact on growth. Moreover, insufficient emphasis on, or delays in, implementing sectoral reform measures can dampen the economy’s supply response to macroeconomic reforms.